30-SBE-008

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
MISS SAYLOR'S CHOCOLATES, INC.)

Appearances:

For Appellant: Ella Saylor, President; M. D. Evans, Secretary-Treasurer; R. Ernest Brotherton, Oakland
For Respondent: A. A. Manship, Assistant Franchise Tax Commissioner

O P I N I O N

This is an appeal, pursuant to Section 25 of the California Bank and Corporation Franchise Tax Act (Chap. 13, Stats. 1929), from the action of the Franchise Tax Commissioner in overruling the protest of Miss Saylor's Chocolates, Inc. against a proposed assessment of an additional tax of $139.32, with interest.

The sole point involved in this appeal is whether or not the Franchise Tax Commissioner proceeded legally in his determination that the tax as disclosed by the return of Miss Saylor' Chocolates, Inc. should be increased to the extent of $139.32 because of what he regarded as an excessive deduction on account of salaries in the calculation of the net income of the corporation. The pertinent provisions of the Act are as follows:

"Sec. 7. The term 'net income', as herein used, means the gross income less the deductions allowed.

"Sec. 8. In computing 'net income? the following deductio shall be allowed:

"(a) All the ordinary and necessary expenses paid or incurred during the taxpayer year in carrying on business, <u>including a reasonable allowance for salaries or other compensation for personal services actually rendered</u>, ****."

To what extent may this Board examine the question of what is "a reasonable allowance for salaries?" In the brief for the Commissioner it is said:

"It is plainly contemplated, and this is universally true in cases where a legislative body has delegated to an administr tive officer the power and duty of determining the question of reasonableness, that the Commissioner shall exercise his own judgment in the matter of what is a reasonable allowance for such compensation and that his determination shall be set aside only upon a clear showing of gross abuse of discretion." (Commissioner's Brief, Page 3.)

We think that such a limited construction of the powers of our Board under the Bank and Corporation Franchise Tax Act (Chapter 13, Statutes 1929) cannot be sustained. Appellate jurisdiction is conferred thereunder in the following language:

"After consideration of the protest and the evidence adduced in the event of such oral hearing, the Commissioner's action upon the protest shall be final upon the expiration of thirty days from the date when he mails to the taxpayer notice of his action, unless within that thirty-day period the taxpayer appeals in writing from the action of the Commissioner to the State Board of Equalization, The appeal must be addressed and mailed to the State Board of Equalization at Sacramento, and a copy of the appeal addressed and mailed at the same time to the Commissioner at Sacramento. The determination by said Board upon said appeal of the amount of the tax shall be final, and said Board shall forthwith notify the taxpayer and the Commissioner of its determination," (Sec. 25, Chap. 13, Stats. 1929).

No specific procedure is prescribed for the consideration of an appeal by the Board, but it is obvious that the statute contemplates that it shall be the duty of the State Board of Equalization to determine, in cases coming before it, the correc amount of the tax. Necessarily such a determination involves mo than the mere decision of whether or not there has been "a gross abuse of discretion on the part of the Commissioner."

Nor is the relation of our Board to the administration of the Bank and Corporation Franchise Tax Act (Chap. 13, Stats. 1929) as casual as the brief of the Commissioner would imply, Although it is provided in Section 22 of the Act that he "shall have power, and it shall be his duty, to administer this act", there is, in the same sentence, provision that "said Commissione and the State Board of Equalization, for the purpose of administering their duties under this act, each shall have the powers conferred upon said Board by Section 3669e of the Political Code of this state."

Section 3669e of the Political Code confers numerous powers upon our Board for the express purpose of enabling us to assess state taxes. We cannot conceive that these same powers have been given to us in connection with the administration of the Bank and Corporation Franchise Tax Act (Chap. 13, Stats. 1929) for no purpose other than to ascertain whether the Commissioner is guilty of gross abuse of discretion.

Giving the statute a reasonable interpretation designed to conserve the rights of the taxpayer, we conclude that it is our duty to determine from the facts before us, through the exercise of our own judgment, what the correct amount of the tax should b

The deficiency assessment which the Commissioner proposes to make results from his disallowance as a deduction from gross income of the sum of $12,440.00, representing a part of the salaries paid to officers of the corporation in 1928. 'These salaries were fixed by a contract made in 1926, four years after

the organization of the corporation under the laws of this state. Certainly, there can be no inference that their amount was influenced by any thought of reducing the tax liability of the company under this act, which had not even been suggested at the time of the contract.

Miss Saylor's Chocolates, Inc. is engaged in the business of manufacturing candy in Alameda. The product is sold at wholesale. There are four officers of the corporation and they own the entire capital stock in equal shares. This arrangement has prevailed since the company was organized under the laws of this state in 1922. The evidence adduced on behalf of the corporation shows that each of the officers-devotes his entire time to its affairs, often working overtime to increase the production or distribution of the company's products.

There is convincing proof that the present business of the corporation is due largely to the personal exertions of its officers. The manufacture of its products is under the discretion of Miss Ella Saylor and Miss Mabel Saylor, who act as plant managers and are, respectively, President and Vice-President of the company. The details of financing and office management are in the hands of M. D. Evans, who is Secretary of the corporation W. B. Saylor acts as Sales Manager, devoting much of his time to personal sales campaigns in which he appears to have been unusually successful. He is also a Vice-President of.the compan According to the contracts under which these individuals have been paid by the corporation since 1926, their compensation has been for services in the capacities above indicated and not for the the discharge of their duties as officers of the Appellant.

Whether the amounts paid constitute compensation for personal services actually rendered or an attempt to distribute profits as salaries, thereby avoiding taxes on corporate income, is, in the last analysis, a question of fact to be decided from all of the evidence. (U. S. V. Philadelphia Knitting Mills, 273 Fed. 657; Appeal of Woodcliff Silk Mills, 1 B.T.A. 715). However, from the action of a Board of Directors in fixing the salary of officers of a corporation, it must be presumed that such salaries are reasonable and proper. (Ox Fibre Brush Co. v. Blair, 32 Fed. (2d) 42, Aff'd. 50 Sup. Ct. Rep. 273.)

In support of his view that the salaries paid the officers of the Appellant in 1928 were unreasonable the Commissioner has directed attention to these circumstances:

1. Each of the officers owns 25% of the capital stock of the corporation.

2. The company insists upon the deduction of approximately 33% of its net *earnings* on account of salaries paid to these officers.

3. The total par value of the corporation's stock, viz., $50,000, exceeds by only $1,120 the amount of the contract compensation paid in a single year to the four officers.

4. The amount of the tax due, when the salaries are deducted, is but $107.30, though the net earnings exclusive of deduction of these salaries approximate $60,000.

As to the Commissioner's first point, it is true that the fact that salaries are paid in proportion to stockholdings is strong evidence of an intent to distribute profits as salaries. The value of services and the amount of stock owned have no necessary relationship to each other. (See appeal of Twin City Tile & Marble Co., 6 B. T. A. 1238; Twin City Tile & Marble Co, Commissioner, 32 Fed. (2d) 229; H. L. Trimyer & Co. v. N&r; ;& Fed.(2d) 781.) This presumption may be overcome, however by evidence showing that the salaries were reasonable for the services rendered and that the value of the services, and not the stockholdings, measured the compensation. (U. S. v. Reitmeyer, 11 Fed. (2d) 648; Austin v. U. S. 28 Fed. (2d) 677; Ox Fibre Brush Co. v. Blair, 32 Fed. (2d) 42; Appeal of Dils Bros. Co., 2 B.T.A. 983; Appeal of E. J. Stilwell Paper Co., 6 B. T. 531.) Moreover, if the amount of stock held is taken into consideration but is not the vital factor *in* fixing salaries, this element alone does not make salaries paid unreasonable so as to preclude the taxpayer from claiming deduction for them. (U. S. v. Reitmeyer, Supra.)

We believe that the taxpayer has furnished sufficient evidence in this appeal to rebut the presumption that the salaries paid to its officers were a distribution of profits. Although it is true that each officer owns the same amount of stock and receives the same salary as the other three officers, we have already pointed out the active part taken by each of them in the company's affairs. This is a close corporation developed solely through the personal efforts, ability and capacity of its stockholders.

Each of these stockholders has been devoting his entire time toward making the business successful. Each of them considers that his services are worth as much to the corporation as the services of any of the other three. Each has separate duties, the performance of which is necessary to the maintenance and development of the business. From what we have said of the corporate organization, it is apparent that the division of responsibility is reasonably equal and that without the combined efforts of all four of the officers, there is little likelihood that the corporation could attain the success which it has. Under these circumstances, we believe that any presumption against reasonableness of the salaries paid the officers, arising from their direct ratio to stockholdings, is overcome.

The Commissioner's second objection to the reasonableness of the salaries in question is apparently predicated upon the theory that by comparing the amount sought to be deducted on this account with the net earnings it is possible to determine whether or not salaries are excessive. While there may be some cases in which such a comparison would be of value, we are inclined to believe that they are sporadic.

Nothing has been suggested to us in this case indicating

any reason why we should consider the salaries excessive merely because of the ratio which they bear to the profits of the business. It seems to us that the true test of the reasonableness of salaries should turn principally upon a consideration of the nature and extent of the business done and the type of service afforded by the individual receiving compensation.

Corporate enterprises frequently must be conducted on a narrow margin of profit even under the most efficient management and, in times of such stress, it would be a peculiar rule which would deny a taxpayer a deduction for salaries paid merely because they were large in comparison with the net income. If a company had not had the type of management worthy of such salaries, it would be conceivable that its loss would be many times greater than the amount expended to assure efficient supervision of the corporate affairs.

As a matter of fact, even after the deduction of salaries claimed by the Appellant, in 1928 the return on the average investment was 14.5499%, so that we find nothing in the circumstances of the case before us to justify the conclusion that the compensation paid was excessive because it represented 83% of the net earnings of the company. In view of the sharply competitive conditions surrounding a business such as this, much must depend upon the excellence of the product, the stability of the financing, and the efficiency of the sales organization. The four officers served the corporation in meeting each of these requirements and, from the results, we must conclude that their efforts were well worth what they were paid,

Concerning the Commissioner's third point, i. e., that the compensation paid the officers for their services in 1928, was almost as much as the total par value of the stock, we think that only brief comment need be made. In the first place, there is no evidence that the par value of the stock is an accurate index of the value of the business. Common experience tells us that it is not. In the second place, the personal efforts of the management of a company such as this constitute a material factor in its success and represent an important part of the entire enterprise. Therefore, we find nothing in the Commission contention regarding the comparison of the par value of the stock and the amount paid as salaries of officers from which we could conclude that these salaries were unreasonable.

The fourth point raised by the Commissioner is so similar to the third that its disposal is almost wholly covered by the same observations. Comparison of the tax paid with the amount allowed for salaries is, in itself, meaningless. During the same period as that involved in this appeal, many large oil companies paid the minimum tax of $25.00 - less than one-quarter as much as this comparatively small candy concern - yet if a comparison should be made between the salaries paid the oil company executives and the taxes paid the state we dare say the contrast would be so much greater than that existing in the case of the Appellant that the latter would fade into insignificance.

No cases in which the Commissioner has adjusted oil company tax on, any such basis as the comparison he now urges before us have come to the attention of our Board.

The gross sales of the Appellant during 1928 were well in excess of $400,000. The salaries paid its officers for the services already described are not disproportionate with the volume of its business. Moreover, as we have indicated, after their payment, the return on average investment was more than 14.5%. Disregard of these factors and comparisonof the tax and the amount paid as salaries do not commend themselves to us as appropriate methods of testing the reasonableness of the salarie

While it is true that the disallowance by the *Commissioner* of a deduction claimed for salaries under subdivision (a) of Section 8 of the Bank and Corporation Franchise Tax Act (Chap, 13, Stats. 1929) does not affect the validity of the contract under which the salaries were paid, none the less a corporation affected by such a ruling may quite naturally resent the implication that it is seeking to avoid its normal tax obligation through the subterfuge of paying its officers more than their services are worth.

The amount of tax at issue in this proceeding is not large but we can appreciate the reasons which impel the management of the company to prosecute the appeal vigorously, Mindful of our function as a part of the tax administration of the state to protect its revenues, we also are conscious of our duty toso administer the law as to avoid, to the best of our ability, requiring any taxpayer to assume more of his share of the burder of government than was intended by statute. In the instant case we are of the opinion that the taxpayer has paid the questioned salaries of $12,200 to each of the officers in good faith; that they were reasonable for the services actually performed; that they were not a device to distribute profits as salaries, and that the corporation correctly reported its tax to the Commissioner in its return for the year ended December 31, 1928,

O R D E R

Pursuant to the views expressed in the opinion of the Board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, that the action of Reynold E. Blight, Franchise Tax Commissioner, in overruling the protest of Miss Saylor's Chocolates, Inc., a corporation, 'against a proposed additional assessment based upon the return of said corporation for the year ended December 31, 1928, under Chapter 13, Statutes of 1929, be and the same *is* hereby reversed Said ruling is hereby set aside and said Commissioner is hereby directed to proceed in conformity with this order.

Done at Sacramento, California, this 4th day of August, 1930, by the State Board of Equalization.

R. E. Collins, Chairman
H. G. Cattell, Member
Jno. C. Corbett, Member
Fred E. Stewart, Member

ATTEST: Dixwell L. Pierce, Secretary